

Cardinal Capital Management, L.L.C.

Small Cap Value

Third Quarter 2019

FIRM OVERVIEW

- Focus on Small & SMID Cap Value
- Experienced, Stable Team
- 25-Year+ Track Record
- FCF-Based Valuations
- 100% Independent, Partner Owned
- \$3.6 Billion AUM

INVESTMENT TEAM

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Market Commentary

Small and large cap stock indices, as represented by the Russell 2000 and 1000, fell 2.4% and rose 1.4%, respectively, in the third quarter. Within the Russell 2000, the Growth Index fell 4.2% while the Value Index fell only 0.6%. The Value Index fell less than its growth counterpart due to a lower weighting in poorly performing healthcare stocks, a higher weighting in better performing financial and real estate stocks, and better performance in consumer discretionary stocks. These were offset by a higher weighting in energy stocks, which lagged despite a major attack on Saudi Arabia's oil infrastructure. Although U.S. equity market indices fell only slightly for the quarter, the market once again experienced significant intra-quarter volatility. In August, the stock market fell sharply as trade talks with China broke down and investors became defensive, fearing an imminent recession. Better economic data and resumption of trade talks in September triggered a rebound in equity prices, particularly those of smaller and more economically sensitive stocks. A more optimistic economic outlook also prompted investors to rotate into value and away from growth stocks because they viewed value stocks as inexpensive. For the quarter, the smallest market capitalization and lowest P/E small cap stocks still lagged despite September's rotation.

U.S. economic growth slowed to 2% in the second quarter as the corporate tax rate cut anniversary faded, and as the trade war with China began to impact the economy. For the rest of the year, economic growth is forecast to remain steady as strong consumer spending is supported by very low unemployment and rising wages. Except for deteriorating manufacturing data, most other economic indicators such as retail sales and the jobless rate have been resilient. Although the Federal Reserve remains optimistic about U.S. economic prospects, it cut short-term interest rates twice this year due in part to concerns about the negative impact of U.S. trade policy on business and consumer confidence. Outside the U.S., economic data remains generally weak. Monetary policy in Europe remains accommodative but ineffective against the structural challenges. Economic growth remains slow in China although the leadership is using monetary and fiscal stimulus to offset the impact of the trade war and global manufacturing weakness. Political uncertainty from the upcoming U.S. presidential election and the impeachment inquiry are also rattling investors who have been net buyers of bonds this year and sellers of equities despite the risk appetite evidenced in September.

Third Quarter Performance Commentary

The preliminary third-quarter performance of Cardinal's Small Cap Value Composite, at 0.9% net of fees, exceeded the -0.6% return of the Russell 2000 Value Index. The main contributors to relative performance were stock selection in the industrials sector, stock selection and a lower weighting in the energy sector, and stock selection in the real estate and communication services sectors. In the industrials sector, the share price of CBIZ, a business services provider, rose after management maintained its forecast for double-digit annual earnings growth despite fewer than expected acquisitions. The stock price of electronics and instrumentation manufacturer Teledyne Technologies rose on better than expected quarterly results and increased annual guidance. In the energy sector, the share price of Canada-based Enerplus performed better than its peers as its results and guidance exceeded analyst expectations. The oil and gas producer also continued to repurchase its shares and increased its remaining authorization. In the real estate sector, the stock prices of health care REITs, Medical Properties Trust, and Community Healthcare Trust, both rose sharply on solid acquisition activity and increased operating cash flow. In the communication services sector, the share price of local TV broadcaster, Nexstar Media rose as it completed its very accretive purchase of

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Tribune Media. The primary detractors from relative performance were stock selection in the information technology and consumer staples sectors and not owning utility stocks. In the information technology sector, the stock price of payment software provider, ACI Worldwide, lagged despite better than expected quarterly results as net new bookings were lackluster. Also, the share price of Cision fell sharply, although the provider of public relations software and analytics lowered its annual EBITDA guidance by just 1%. Shareholders have lost patience with management due to the levered nature of the company's balance sheet. In the consumer staples sector, the stock price of MGP Ingredients fell after the distiller reported lower than expected quarterly results due to a slower ramp in the sale of its high margin aged whiskey inventory.

The annualized net return of Cardinal's Small Cap Value Composite since inception (July 1, 1992) is 11.9% versus 10.4% for the Russell 2000 Value Index and 9.5% for the Russell 2000 Index. Cardinal managed \$3.6 billion in small and SMID cap value assets as of September 30, 2019.

Highlighted Investments



Itron, Inc. provides technology and services that measure, analyze, and manage energy and water use globally. The company is a key player in the transformation of power generation and distribution into smart cities with clean energy. With its origins as a supplier of utilities meters, Itron now provides products and solutions that enable automated meter reading, advanced metering infrastructure, as well as an enterprise software platform with real-time analytic applications. These solutions assist electric, gas, and water utilities in efficiently managing their infrastructure resources. One important driver of demand is the poor condition of the electrical grid worldwide. Itron is well-positioned as one of the few vendors with market-leading products and solutions capable of making significant and complex upgrades. Moreover, the substantial increase in electric vehicles forecast to meet more stringent carbon emission standards will only increase the demands on the grid. In 2018, Itron acquired Silver Spring Networks for its open-source software platform, which allows cities, utilities, and other enterprises to achieve a higher return on their infrastructure investments by deploying applications on an integrated networking and data platform. As a result, Itron can analyze data gathered from the grid and process it into information which its customers can use to optimize their operations. Following the acquisition, industrywide component shortages reduced Itron's gross margin as it was moving to a more outsourced, flexible manufacturing model. The negative earnings revisions which occurred as the company was reducing its cost structure enabled Cardinal to build a meaningful position in the company at an attractive valuation. Currently, management is realizing \$140 million in synergies from the Silver Springs acquisition and its supply chain restructuring. They intend to use their free cash flow primarily to reduce leverage taken on in the Silver Springs transaction. With the component shortages largely behind them, Itron is well-positioned to benefit from the increasing demand for clean and sustainable energy infrastructure.



Lithia Motors is the third-largest car dealer group in the U.S. Although over 50% of its revenue comes from the cyclical business of selling new cars, over 80% of its profits come from used car sales and other more stable sources, such as parts, maintenance, and repair services. Founded in 1946 as a single Chrysler dealership, Lithia began to acquire other dealerships in the late 1960s but increased its efforts after the company went public in 1996. Cardinal analyzed auto dealerships after the financial crisis but concerns about the dealership model and its dependence upon floor plan financing from financially challenged manufacturers deterred the team from investing. However, the portfolio managers became comfortable with the business model over time, as the financial condition of the manufacturers has improved. Since the average vehicle on the road today is 12 years old and low-cost credit is available, new car demand remains stable. Also, consolidation of the highly fragmented auto dealership industry has continued as baby boomers reach the age at which they choose to sell their businesses. Lithia has been a disciplined acquirer of dealerships that have not performed near their potential, typically paying three to five times normalized cash flow. Management's data-driven focus and investments in systems and technology have allowed Lithia to improve the profitability of acquisitions over time. Following a quarter where Lithia missed analyst earnings estimates due to the liquidation of excess used car inventory at unfavorable rates, Cardinal was able to buy the company's stock at an opportunistic valuation. Since then, its earnings have grown over 10% per year despite a plateauing of new car sales. Lithia's stock has risen in line with its earnings growth but remains attractively valued relative to its solid fundamental prospects. With over \$1.2 billion of recently acquired revenues and management's solid track record of execution, the company should improve its profitability as the performance of newer dealerships reaches peer levels.

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Market & Portfolio Outlook

Cardinal's near-term outlook for equities remains cautiously optimistic despite significant trade uncertainties, mixed domestic economic data, and a volatile political situation. Monetary policy should prove to be a tailwind as the Federal Reserve appears committed to more interest rate cuts to help sustain the current record-long economic expansion. The investment team expects U.S. GDP to grow moderately into 2020 as strong consumer spending more than offsets the weak manufacturing environment. It is too early to determine the degree of negative impact recent tariff increases will have, particularly on consumer and business confidence. With heightened uncertainty, the investment team continues to prefer investments whose success is dependent primarily upon company-specific drivers rather than overall economic growth. The portfolio managers remain optimistic that Cardinal's portfolio companies will continue to redeploy their free cash flow opportunistically, which should bode well for future value creation.

Disclosures

Net performance reflects the deduction of advisory fees and expenses which reduce an investor's total return on investment. Returns presume investment for the entire period indicated and reinvestment of all interest income, capital gains, dividends and other distributions. Performance returns are unverified estimates and have been computed by Cardinal. Depending on the timing of an investor's investment in the strategy, net performance for such investor may vary from the net performance stated herein. Past performance is not indicative of future results.

The Russell 2000™ Index consists of the 2000 smallest stocks in the Russell 3000 Index that represent approximately 10% of the total market capitalization of that Index. The Russell 1000 Index consists of the 1000 largest stocks in the Russell 3000 Index that represent approximately 90% of the total market capitalization of that Index. The Russell 2000 Value Index measures the performance of the small-cap value segment of the U.S. equity universe and includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe. It includes those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. These indices are included merely to show the general trend in the small-cap equity markets in the periods indicated and is not intended to imply that Cardinal's investments were comparable to the index either in comparison or element of risk. There is no guarantee that the performance of the strategy will meet or exceed any index. An investor cannot invest directly in an index.

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